

GARNETT AND THOMPSON: LLC AND LLP LOSSES NO LONGER PASSIVE *PER SE*

JONATHAN W. THOMAS^{*}

I. INTRODUCTION

Seemingly perpetual net operating losses. Less personal income. Same personal tax liability for business entities taxed as partnerships under Federal law. Proposed higher marginal tax rates. These factors over the past 18-24 months have led to uncertainty in the United States economy and stymied both investment and the creation of new businesses. Two recent decisions, *Garnett v. Commissioner*¹ (*Garnett*) and *Thompson v. United States of America*² (*Thompson*) offer potential economic relief to taxpayers that hold interests in limited liability companies (LLCs) and limited liability partnerships (LLPs). The United States Tax Court's and the United States Court of Federal Claims' decisions in these two cases will now make it easier for taxpayers to demonstrate they are "material participants" in their respective LLCs and LLPs. Since it will now be easier for taxpayers to demonstrate their material participation, they will potentially be able to offset their ordinary income with losses from their interests in LLCs and LLPs rather than only being permitted to use those losses to offset their passive activity income or having to carry them over to the next taxable year as passive activity credits under I.R.C. § 469. At a time when many LLCs and LLPs are generating net operating losses instead of profits, the ability of taxpayers to deduct their pro rata share of those losses from their ordinary income means they could see a reduction in their tax liability and LLCs and LLPs may become an attractive investment tool.

In addition to this introductory section, this note will contain four additional sections. In Section II, four topics will be discussed: (1) the history, legislative intent and effect of I.R.C. § 469(h)(2) on limited partnerships; (2) the creation of LLCs and their tax treatment as partnerships by the IRS; (3) why the IRS believes that interests held in LLCs are limited partnership interests and (4) how the United States District Court for the District of Oregon's decision in *Gregg v. U.S.*³ set forth the legal and analytical framework for the decisions rendered in

^{*} Juris Doctor, The Ohio State University Moritz College of Law, expected 2011.

¹ See generally *Garnett v. Comm'r*, 132 T.C. No. 19 (2009).

² See generally *Thompson v. United States*, 87 Fed. Cl. 728 (Fed. Cl. 2009).

³ *Gregg v. United States*, 186 F. Supp. 2d 1123, 1125 (D. Or. 2000).

Garnett and *Thompson*. In Section III, the analysis of the United States Tax Court's decision in *Garnett* will be discussed. In Section IV, the analysis of the United States Court of Federal Claims' decision in *Thompson* will be discussed. Section V will conclude this note with a discussion of how *Garnett* has already yielded a positive result for taxpayers in the United States Tax Court's decision in *Hegarty v. Commissioner*⁴ and how the legal analysis set forth in both *Garnett* and *Thompson* might have an unintended consequence for taxpayers with respect to I.R.C. § 1402 self-employment taxes.

II. I.R.C. § 469: ERADICATION OF TAX-SHELTERS

Section 469 of the Internal Revenue Code (IRC) disallows certain taxpayers from offsetting their ordinary income with losses or credits from their passive activities.⁵ Passive activities are further defined as “. . . any activity in which the taxpayer does not materially participate.”⁶ A taxpayer is considered to materially participate in any activity in which they participate on a “regular, continuous and substantial basis.”⁷ Section 469 of the IRC was enacted as part of the Tax Reform Act of 1986 (TRA).⁸ Prior to the enactment of the TRA, there was generally no limitation on the ability of taxpayers to use deductions from one or more activities to offset income derived from other activities.⁹ Congress and the Internal Revenue Service (IRS) considered this tax-shelter practice as the underlying reason taxpayers were losing faith in the federal income tax system and creating a prolific expansion of tax shelters.¹⁰ To restore faith in the federal income tax system and limit tax shelters, Congress viewed § 469 as a way of making it more difficult for passive investors to use losses from their passive activities to offset their ordinary income:

⁴ *Hegarty v. Comm'r*, No. 3730-07S, 2009 Tax Ct. LEXIS 154, at *8 (T.C. Oct. 6, 2009).

⁵ I.R.C. § 469(a)(1) (West 2009). “If for any taxable year, the taxpayer is a person described in paragraph (2), neither --- (A) the passive activity loss, nor (B) the passive activity credit, for the taxable year shall be allowed.” *Id.* “The following persons are described in this paragraph: (A) any individual, estate or trust, (B) any closely held C corporation, and (C) any personal service corporation.” I.R.C. § 469(a)(2).

⁶ I.R.C. § 469(c)(1). The term ‘passive activity’ means any activity – (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate. I.R.C. § 469(c)(2).

⁷ I.R.C. § 469 (h)(1). “A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is – (A) regular, (B) continuous and (C) substantial.” *Id.*

⁸ STAFF ON J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 209 (1987).

⁹ *Id.*

¹⁰ *Id.*

In recent years, it has become increasingly clear that taxpayers are losing faith in the federal income tax system. This loss of confidence has resulted in large part from . . . the opportunities it provides for taxpayers to offset income from one source with tax shelter deductions and credits from another . . . The prevalence of tax shelters in recent years has been well documented Such patterns give rise to a number of undesirable consequences, even aside from their effect in reducing federal tax revenues. Extensive shelter activity contributes to public concerns that the tax system is unfair, and to the belief that tax is paid only by the naive and the unsophisticated. This, in turn, not only undermines compliance, but encourages further expansion of the tax shelter market, in many cases diverting investment capital from productive activities to those principally or exclusively serving tax avoidance goals The committee believes that the most important sources of support for the federal income tax system are the average citizens who simply report their income (typically consisting predominantly of items such as salaries, wages, pensions, interest, and dividends) and pay tax under the general rules. To the extent that these citizens feel that they are bearing a disproportionate burden with regard to the costs of government because of their unwillingness or inability to engage in tax-oriented investment activity, the tax system itself is threatened Under these circumstances, the committee believes that decisive action is needed to curb the expansion of tax sheltering and to restore to the tax system the degree of equity that is a necessary precondition to a beneficial and widely desired reduction in rates. So long as tax shelters are permitted to erode the federal tax base, a low-rate system can provide neither sufficient revenues, nor sufficient progressivity, to satisfy the general public that tax liability bears a fair relationship to the ability to pay. In particular, a provision significantly limiting the use of tax shelter losses is unavoidable if substantial rate reductions are to be provided to high-income taxpayers without disproportionately reducing the share of total liability under the individual income tax that is borne by high-income taxpayers as a group.¹¹

¹¹ *Id.* at 211-12.

A. I.R.C. § 469(h)(2): The Limited Partnership Restriction

The effect of § 469(h)(2) is that any limited partnership interest held by a limited partner is presumptively treated as an interest in which the taxpayer is passive and does not materially participate.¹² Like other taxpayers, limited partners holding a limited partnership interest¹³ can demonstrate their material participation in their trade or business by using the material participation tests set forth in 26 C.F.R. § 1.469-5T(a)(1)-(7).¹⁴

¹² I.R.C. § 469(h)(2): “[e]xcept as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.”

¹³ 26 C.F.R. § 1.469-5T(e)(3) (2009) defines a limited partnership interest as: [A] partnership interest shall be treated as a limited partnership interest if-- (A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or (B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder’s capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).

Id.

¹⁴ 26 C.F.R. § 1.469-5T(a).

Except as provided in paragraphs (e) and (h)(2) of this section, an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if—

- (1) The individual participates in the activity for more than 500 hours during such year;
- (2) The individual’s participation in the activity for the taxable year constitutes substantially all of the participation in such activity for all individuals, (including individuals who are not owners of interests in the activity), for such taxable year;
- (3) The taxpayer participates in the activity for more than 100 hours during the taxable year, and such individual’s participation in the activity for the taxable year is not less than the participation in the activity of any other individual, (including individuals who are not owners interests in the activity) for such taxable year;
- (4) The activity is a significant participation activity[] for the taxable year, and the individual’s aggregate participation in all significant participation activities during such taxable year exceeds 500 hours;

However, 26 C.F.R. § 1.469-5T(e)(2) works in tandem with § 469(h)(2) by only allowing limited partners holding a limited partnership interest to demonstrate they are material participants by using three of the seven tests set forth in 26 C.F.R. § 1.469-5T(a): (1), (5) and (6). These three tests read, respectively:

(a)(1) The taxpayer participates in the activity for more than 500 hours during such year.¹⁵

(a)(5) The taxpayer materially participated in the activity for any 5 taxable years, whether or not consecutive, during the 10 taxable years immediately preceding the taxable year.¹⁶

(a)(6) The activity is a personal service activity and the taxpayer materially participated in the activity for any 3 taxable years, whether or not consecutive, preceding the taxable year.¹⁷

The language of § 469(h)(2) and 26 C.F.R. § 1.469-5T(e)(2) reflects Congress' principal concern regarding tax-shelter abuse and the interrelationship between this practice with limited partnerships. In the time period leading up the TRA, Congress felt that limited partnerships were among the most prevalent and widely used tax shelters. Further, Congress knew that under relevant state laws, limited partners in a limited partnership lost their limited liability protection if they were materially active; thus, Congress presumed that limited partners were not material participants.¹⁸ Therefore, the enactment of § 469(h)(2) accomplished Congress' intent of limiting tax-shelter abuse in limited partnerships and restoring trust in the federal tax system: by presumptively characterizing a limited partner in a limited partnership as being passive instead of materially active in the partnership, and in disallowing passive activity

-
- (5) The individual materially participated in the activity[] for any 5 taxable years, (whether or not consecutive) during the 10 taxable years that immediately preceding the taxable year;
 - (6) The activity is a personal service activity and the taxpayer materially participated in the activity for any 3 taxable years, (whether or not consecutive) preceding the taxable year; or
 - (7) Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such taxable year.

26 C.F.R. § 1.469-5T(a)(1)-(7).

¹⁵ 26 C.F.R. § 1.469-5T(a)(1).

¹⁶ 26 C.F.R. § 1.469-5T(a)(5).

¹⁷ 26 C.F.R. § 1.469-5T(a)(6).

¹⁸ STAFF ON J. COMM. ON TAXATION, *supra* note 8.

losses to be used in the offsetting of ordinary income, limited partnerships were no longer a viable entity in tax-shelter abuse.

B. A Brief History: The Limited Liability Company and Federal Taxation Treatment by the IRS

When the TRA was enacted in 1986, LLPs did not exist and only one state had a registered LLC.¹⁹ In 1977, the state of Wyoming created the first limited liability act in the United States.²⁰ In 1982, the state of Florida created the second state limited liability company statute in the United States.²¹ Despite the attractiveness of LLCs – limited liability protection for members, the same protection provided to shareholders in a corporation, and the pass-through taxation feature as opposed to the double-taxation feature of corporations – only one LLC was registered between 1977 and 1986.²² It is widely believed that the reluctance of states to enact LLC statutes and taxpayers failure to register them in the states where statutes were enacted, was due to the uncertainty as to how the IRS would treat them for taxation purposes: as a corporation, or as a partnership under the “Kintner Regulations.”²³

¹⁹ The first LLP was registered in 1991 and in 1986 Wyoming had the only registered LLC. *Garnett*, 132 T.C. No. 19 at 12.

²⁰ CORP LLC, <http://www.corporllc.com/llchistory.html> (last visited May 13, 2009).

²¹ *Id.*

²² *Garnett*, 132 T.C. No. 19 at 12.

²³ Steven A Dean, *Attractive Complexity: Tax Deregulations, The Check-The-Box Election And The Future Of Tax Simplification*, 34 HOFSTRA L. REV. 402, 426 (1996). The “Kintner Regulations” were promulgated by the IRS in response its loss in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954). In *Kintner*, a physician and his partner were not permitted, by way of state law, to create a business entity that was a corporation. Nonetheless, they were able to form a business entity that was a partnership for state law purposes, but qualified as a corporation for federal tax purposes.

As indicated by Dean, the IRS perceived this a manipulation of the current tax code because in creating the corporation for federal taxation purposes, Kintner and his partner were able to take “advantage of tax-favored pension at the time only available to corporations” and would not be personally liable for their entity’s tax liability. *Id.* As a result, the IRS promulgated the Kintner Regulations for the purpose of making it more difficult “for taxpayers to achieve corporate tax status for unincorporated entities, including partnerships.” *Id.* The six criteria contained in the Kintner Regulations were:

- (1) associates;
- (2) an objective to carry on business and divide the gains therefrom
- (3) continuity of life;
- (4) centralized management;
- (5) liability for corporate debts limited to corporate property and

From 1977 until 1988, the IRS gave states little guidance as to how they would treat an LLC for taxation purposes.²⁴ Then, in 1988, the IRS issued Revenue Ruling 88-76,²⁵ which announced its intention to treat the only LLC registered in the state of Wyoming, and in the United States, as a partnership rather than a corporation for taxation purposes.

To further facilitate the federal taxation treatment of LLCs as partnerships and not corporations, the IRS issued Notice 98-11 in 1996, which went into effect in 1997 as 26 C.F.R. §§ 301.7701-1, 301.7701-2 and 301.7701-3, better known as the “check-the-box regulations.”²⁶ The issuance of these “check-the-box” regulations is considered important in the movement to “simplify tax law” because unlike the “Kintner Regulations,” it allows taxpayers (with a few exceptions) to determine how their business entities will be classified for federal taxation purposes by simply filing out a form which contains the requisite “boxes” to “check.”²⁷

(6) free transferability of interests

While there were six criteria listed, the IRS used (3)-(6) as part of its “preponderance test.” *Id.* at 426-427. Under the “preponderance test,” in order for an unincorporated entity to be classified as a corporation for federal tax purposes, it must have possessed three of the four aforementioned characteristics; thus, if it possessed two or less, it was a partnership. *Id.*

²⁴ Donald A. Frederick, *The ABCs of LLCs: Limited Liability Companies Offer New Option for Rural Businesses*, RURAL COOPERATIVES, July/August, at 36, available at <http://www.uwcc.wisc.edu/info/farmer/pre2001/abc.html>.

²⁵ *Id.*

²⁶ Dean, *supra* note 23.

²⁷ *Id.* Under I.R.C. § 301.7701-3(a), an “eligible entity,” that is, an entity that is not classified as a corporation under 301.7701-2(b)(2), “can elect its classification for federal tax purposes.” 26 C.F.R. § 301.7701-2(b) lists the following entities as corporations, and thus ineligible to elect their classification for taxation purposes:

- (1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;
- (2) An association (as determined under section 301.7701-3);
- (3) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;
- (4) An insurance company;
- (5) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute;
- (6) A business entity wholly owned by a State or any political subdivision thereof;

C. *The IRS' Position on LLCs and LLPs: Section 469(h)(2) Applies*

The position of the IRS is that § 469(h)(2) applies to interests held in LLCs and LLPs, because both of these business entities can be taxed as a partnership rather than a corporation, under the laws of the state in which they are registered.²⁸ Further, the IRS considers these interests to be held as a limited partner in a limited partnership within the meaning of 26 C.F.R. § 1.469-5T(e)(3) because the central feature of being a limited partner in a limited partnership – limited liability protection is afforded to members of LLCs and LLPs.²⁹ Therefore, it is the position of the IRS that members of LLCs and LLPs are subject to § 469(h)(2) and the subsequent restrictions for demonstrating material participation as a limited partner in a limited partnership set forth in 26 C.F.R. § 1.469-5T(e)(2).

D. *Gregg v. United States: The Beginning of the End for the IRS' Position That Section 469(h)(2) Applies To Interests Held in LLCs and LLPs?*

Nine years before the United States Tax Court's ruling in *Garnett* and the United States Court of Federal Claim's ruling in *Thompson*, the United States District Court for the District of Oregon held in *Gregg* that the taxpayer's pass-through loss stemming from his interest held in Cadaja, LLC (Cadaja)³⁰ an Oregon LLC, was an ordinary loss.³¹

(7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3).

Id. § 301.7701-2(b). Further, under 26 C.F.R. § 301.7701-3(a), an eligible entity” [W]ith at least two members can elect to be classified as an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Id.

With this, taxpayers who wish to create a limited liability company can do so, and determine their classification for federal tax purposes by simply, “checking-the-box” they wish: corporation [association] or partnership.

²⁸ *Thompson*, 87 Fed. Cl. at 728.

²⁹ *Id.*

³⁰ According to the Affidavit in Support of Plaintiff's Motion for Summary Judgment, Cadaja, LLC was organized under the laws of the State of Oregon on November 4, 1994. *Gregg v. United States*, 186 F. Supp. 2d 1123, 1125 (D. Or. 2000). The plaintiff, along with two other persons, formed Cadaja, LLC for the purpose “creating a network of credentialized alternative medicine practitioners and develop management capability for alternative medicine clinics” and plaintiff was the sole financier. *Id.* Cadaja, LLC had no formal office until 1995 with the plaintiff and the other two members of Cadaja, LLC working out of the office of

In *Gregg*, the petitioner sued the IRS in the United States District Court for the District of Oregon seeking a refund of his income taxes paid, plus interest penalties with respect to the pass-through loss from Cadaja he used to offset his ordinary income.³² In support of his claim for a refund, the petitioner asserted that he was a general partner for purposes of federal income taxation and was therefore, not subject to the limitations on interests held as limited partner in limited partnerships set forth in § 469(h)(2).³³ The petitioner grounded his position upon the Oregon Limited Liability Act (OLLA) and noted that under the Act, a general partner in an LLC was determined based upon its “control of” rather than its “liability for” the LLC.³⁴ The petitioner asserted that he should be considered a general partner for purposes of § 469 since neither the petitioner nor the other two members of Cadaja were subject to restrictions on their participation or

Ethix Corporation. *Id.* Further, Cadaja, LLC had no Operating Agreement until 1995; when its name was changed to “Alternare Group, LLC.” *Id.* For the tax period in question – November 4, 1994 through December 31, 1994 – the petitioner worked “approximately” 100 hours for Cadaja, LLC for which he received no compensation and Cadaja, LLC sustained a net loss of \$230,723. *Id.*
³¹ *Gregg*, 186 F. Supp. 2d at 1134.

³² *Id.* at 1124. The IRS disallowed the plaintiff’s flow-through loss from Cadaja in the amount of \$230,723 in its Notice of Deficiency issued on March 3, 1998. *Id.* The notice set forth the following amounts with respect to the claimed flow-through loss:

3/3/98 IRS Notice of Deficiency	Deficiency Amount	Accuracy-Related Penalty
	\$91,366.00	\$18,273.20

With no action taken by the plaintiff, the IRS made the following assessments on July 27, 1998 with respect to the plaintiff’s \$230,723 flow-through loss:

7/27/98 IRS Assessment of Deficiency	Audit Deficiency	Accuracy-Related Penalty	Interest on Deficiency
	\$91,366.00	\$18,273.20	\$36,281.76

On August 13, 1998, plaintiff paid the \$91,366 audit deficiency and sought a refund, which the IRS disallowed on January 11, 2000. *Id.* On August 26, 1999, plaintiff made a payment of \$26,530 towards the accuracy-related penalty and sought a refund, which the IRS disallowed on November 10, 1999. *Id.* at 1125-26.

³³ *Id.* at 1127.

³⁴ *Id.* (As the district court noted, under Oregon law, “general partner status is conferred upon a partner who is not subject to restrictions upon participation in the control of the business”).

control of Cadaja's business under Oregon law or Cadaja's Articles of Organization and Operating Agreement.³⁵

The IRS counter-argued that the OLLA was pre-empted by § 469(h)(2) and its regulations as promulgated by the Secretary of the United States Treasury.³⁶ The IRS then relied upon the language of 26 C.F.R. § 1.469-5T(e)(3)(i)(B) to support its position that the petitioner was a limited partner for purposes of § 469(h)(2): "[a] partnership interest shall be treated as a limited partnership interest if . . . [t]he liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount."³⁷

Since the petitioner and the other two members of Cadaja were afforded limited liability protection under the OLLA and Cadaja's Operating Agreement, the IRS alleged the petitioner (1) held a limited partnership interest in Cadaja (2) he was a limited partner subject to the limited partnership restriction set forth in Section 469(h)(2) and, (3) he improperly used the \$230,723 in passive losses to offset his ordinary income.³⁸

The district court disagreed with the IRS' position and held that neither the limited partnership test promulgated in 26 C.F.R. § 1.469-5T(e)(3)(i)(B) nor, the heightened material participation tests for limited partners promulgated in 26 C.F.R. § 1.469-5T(e)(2) applied to members of LLCs. Accordingly, the court ruled that members, like the petitioner, could demonstrate material participation pursuant to all seven tests set forth in 26 C.F.R. § 1.469-5T(a)(1)-(7).³⁹

The district court's rejection of the IRS' position was three-fold. First, the district court noted "a limited partnership must have at least one general partner who is personally liable for the obligation of the limited partnership."⁴⁰ However, if the IRS' position was adopted and *all* members of a LLC were treated as limited partners, and all LLCs were treated as limited partnerships for federal tax purposes, then they would all be missing the requirement of having at least "one general partner who is personally liable for the obligation of the limited partnership."⁴¹

³⁵ *Gregg*, 186 F. Supp. 2d at 1127-28.

³⁶ *Id.*

³⁷ *Id.* (emphasis added). For example, the sum of the holder's capital contribution to the partnership and contractual obligations to make additional capital contributions to the partnership.

³⁸ *Id.* Furthermore, the IRS took the even broader position that all members of LLCs were limited partners for purposes of I.R.C. § 469(h)(2).

³⁹ *Id.* at 1128-29.

⁴⁰ *Id.*

⁴¹ *Id.*

Second, the district court noted that in a limited partnership a limited partner cannot participate in the management of the limited partnership and simultaneously maintain their limited liability protection.⁴² However, members of a LLC *can* maintain limited liability protection irrespective of whether they participate in the management of the limited liability company.⁴³ Therefore, the district court reasoned, a limited partner in a limited partnership is not akin to a member of a LLC and thus, the LLC should not be subject to the limited partnership test contained in 26 C.F.R. § 1.469-5T(e)(3)(i)(B) or the limited partnership restriction of § 469(h)(2).⁴⁴

Third, the district court noted that Congress' intent in enacting § 469(h)(2) was to prevent the ability of limited partners in limited partnerships from using passive activity losses to offset their ordinary income and create tax-shelters because "a limited partner generally is precluded from participating in the partnership's business if he is to retain his limited liability status."⁴⁵ And, as discussed above, because a member of an LLC is permitted by law and Operating Agreements to participate in the management of the LLC and maintain their limited liability protection, Congress most likely did not have members of LLCs in mind when enacting § 469(h)(2).⁴⁶

The district court then held that the petitioner should be characterized as a material participant in the business operations of Cadaja "if and only if" he satisfied one of the seven tests set forth in 26 C.F.R. § 1.469-5T(a)(1)-(7).⁴⁷ Since his participation in Cadaja only amounted to 100 hours, the petitioner was unable to satisfy 26 C.F.R. § 1.469-5T(a)(1).⁴⁸

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at 1129.

⁴⁸ *Id.* According to 26 C.F.R. § 1.469-5T(a)(1): "[t]he taxpayer [must] participate in the activity for more than 500 hours during such year." *Id.* The petitioner asserted this test also sets forth a "quantitative measure" of material participation based upon the following mathematical computations: "Five hundred hours per year equates to 9.62 hours per week, or 10.42 hours per week assuming 48 work-weeks per year." *Gregg*, 186 F. Supp. 2d at 1129.

The petitioner then asserted he worked 112 hours at Cadaja, LLC for the eight-week period between November 4, 1994 and December 31, 1994. *Id.* Since this equals 14 hours a week and a prorated amount of 728 hours per year, and 14 hours a week is more than 9.62 and 10.42, and 728 hours is more than 500, the petitioner reasoned he satisfied 26 C.F.R. § 1.469-5T(a)(1) on a "pro rata basis." *Id.*

The petitioner was unable to satisfy 26 C.F.R. § 1.469-5T(a)(2) and (3) because the other two members of Cadaja, according to the Statement of Facts, each worked 40 hours per week during the eight-week period from November 4, 1994, to December 31, 1994, which was more than the petitioner worked during that time period.⁴⁹

Despite his “aggregate participation in significant participation activities for such taxable year” exceeding 500 hours, the petitioner was also unable to satisfy 26 C.F.R. § 1.469-5T(a)(4).⁵⁰ The petitioner’s argument under 26 C.F.R. § 1.469-5T(a)(4) that he was a material participant in Cadaja was based upon his work as a “[f]ull-time CEO of Ethix Corporation (Ethix) working at least 40 hours per week on a continuous basis until he terminated his employment with the corporation in November of 1994.”⁵¹

The district court rejected this assertion for the same two reasons articulated by the IRS. *Id.* First, the IRS reasoned the language “if and only if” contained in 26 C.F.R. § 1.469-5T(a) reflected Congress’ intent of only allowing the seven enumerated tests, as they stood, to be the measure of material participation. Second, the IRS noted that on a pro rata basis, five hundred hours per year is less than ten hours per week. *Id.* If the IRS allowed persons to establish material participation based upon such a “de minimis” standard, the congressional intent behind I.R.C. § 469(h)(2) would be frustrated: to prevent persons from acquiring passive-activity interests in a business towards the close of a taxable year and then using losses from that activity as non-passive losses to offset their taxable income. *Id.*

⁴⁹ *Id.* at 1130. As the District Court noted, the petitioner did not assert his material participation in Cadaja, LLC under either of these two tests, which read:

26 C.F.R. § 1.469-5T(a)(2): The taxpayer’s participation in the activity for the taxable year *constitutes substantially all of the participation in such activity for all individuals*, including individuals who do not own interests in the activity, for such taxable year.

26 C.F.R. § 1.469-5T(a)(3): The taxpayer participates in the activity for more than 100 hours during the taxable year, *and the taxpayer’s participation in the activity for the taxable year is not less than the participation in the activity of any other individual*, including individuals who do not own interests in the activity, for such taxable year.

Id. (emphasis added).

⁵⁰ *Id.* According to 26 C.F.R. § 1.469-5T(a)(4) : “[t]he activity [must be] a significant participation activity for the taxable year, and the taxpayer’s aggregate participation in significant participation activities for such taxable year exceeds 500 hours.”

⁵¹ *Gregg*, 186 F. Supp. 2d at 1130.

Since the petitioner's work at Ethix met the definition of "significant participation" under 26 C.F.R. § 1.469-5T(c)(2)⁵² because he worked more than 500 hours at Ethix in the taxable year of 1994 and, he also worked approximately 100 hours at Cadaja in the taxable year of 1994, the petitioner reasoned that his "aggregate participation in all significant participation activities during such year exceeds 500 hours."⁵³ With that, the petitioner asserted he was a material participant in Cadaja during the taxable year of 1994 and his pro rata share of its loss, \$230,723, should be characterized as ordinary, and not passive.⁵⁴

The district court agreed with the petitioner that his participation at Ethix was sufficient to constitute "significant participation" within the definition of 26 C.F.R. § 1.469-5T(c)(2); however, due to his 500-plus hours of participation therein, petitioner "erred in mis-characterizing it as a significant participation activity within the meaning of 26 C.F.R. § 1.469-5T(c)(ii)."⁵⁵ The district court reasoned that because he worked at Ethix for 40 hours a week from January of 1994 through November of 1994, petitioner was a material participant at Ethix under 26 C.F.R. § 1.469-5T(a)(1): "[t]he individual participates in the activity for more than 500 hours during such year."⁵⁶ However, the requirement set forth in 26 C.F.R. § 1.469-5T(c)(ii) for "significant participation activity" is that the activity *would not be* one in which the taxpayer is deemed to be a material participant "*without regard to paragraph (a)(4) of this section*."⁵⁷ Conversely, the district court concluded the petitioner's 100 hours of participation at Cadaja fell outside the bounds of material participation under 26 C.F.R. § 1.469-5T(a)(4).⁵⁸

⁵² *Id.* According to 26 C.F.R. § 1.469-5T(c)(2), "significant participation" is defined as: "[a]n individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year."

⁵³ *Gregg*, 186 F. Supp. 2d at 1130.

⁵⁴ *Id.*

⁵⁵ *Id.* In 26 C.F.R. § 1.469-5T(c), "significant participation activity" is defined as:

a trade or business activity (within the meaning of 26 C.F.R. 1.469-1T(e)(2)) in which the individual significantly participates for the taxable year; and (ii) *[w]ould be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section*.

Id. (emphasis added).

⁵⁶ *Gregg*, 186 F. Supp. 2d at 1127.

⁵⁷ *Id.* at 1131 (emphasis added).

⁵⁸ *Id.*

In the end, petitioner successfully demonstrated his material participation in Cadaja under 26 C.F.R. § 1.469-5T(a)(1) by asserting his activities at Ethix and Cadaja should be grouped together as a “single activity” for purposes of 26 C.F.R. § 1.469-5T(a)(5) and (6):

26 C.F.R. § 1.469-5T(a)(5). The taxpayer materially participated in the activity for any 5 taxable years, whether or not consecutive, during the 10 taxable years immediately preceding the taxable year.

26 C.F.R. § 1.469-5T(a)(6). The activity is a personal service activity and the taxpayer materially participated in the activity for any 3 taxable years, whether or not consecutive, preceding the taxable year.⁵⁹

The district court accepted the petitioner’s proposition that even though Cadaja was formed in 1994—which would have rendered the petitioner unable to satisfy either the three year or five year requirement of material participation contained in both 26 C.F.R. § 1.469-5T(a)(5) and (6)—his material participation in Ethix should be considered in its analysis of his activities at Cadaja, because of the ability for taxpayers to “group” activities under 26 C.F.R. § 1.469-4(a) for § 469 purposes.⁶⁰

⁵⁹ *Id.* at 1133. The district court analyzed these two tests together due to the “common question” of material participation. *Id.* Accordingly, the analysis was whether or not the plaintiff materially participated in the activity for any five taxable years during the ten taxable years immediately preceding the taxable year of 1994 and whether or not that activity was a personal service activity in which the plaintiff materially participated for any three taxable years preceding the taxable year of 1994. *Id.*

⁶⁰ *Id.* Before it could proceed with its “grouping” analysis, the district court had to reject the IRS’ assertion that the petitioner was barred from raising a “grouping” argument under the “doctrine of variance.” *Id.* The district court noted that under I.R.C. § 7422(a), a taxpayer “may not raise a claim in a refund action that was not raised in the administrative process of a claim for refund.” *Gregg*, 186 F. Supp. 2d at 1133. It was this language that formed the basis of the IRS’ position that because the petitioner did not raise the grouping of his participation in both Ethix Corporation and Cadaja, LLC until his “Memorandum in Support of Plaintiff’s Motion for Summary Judgment,” the doctrine of variance barred the grouping. *Id.* The district court rejected the IRS’ position and continued on with its analysis of grouping together the plaintiff’s activity in Ethix Corporation and Cadaja, LLC for five reasons. *Id.*

First, the district court noted that the purpose of the doctrine of variance “is to prevent surprise and give the IRS adequate notice of the claim and its underlying facts so that it can make an administrative investigation and determination regarding the claim.” *Id.* Second, the district court noted that while the plaintiff’s broad Claim of Refund did not, “on its face,” call for an “investigation” by the IRS as to whether or not grouping could occur and could therefore be barred by the doctrine of variance, the “grouping argument was only

The district court noted that under 26 C.F.R. § 1.469-4(a), taxpayers may group together their trade or business activities, including C corporations subject to § 469, for the purpose of defining “activity” with respect to § 469 passive activity losses and that “no dispute arose to the fact that Ethix is a C corporation subject to section 469.”⁶¹ Therefore, the district court first had to determine whether or not the petitioner could attempt to group together his activities at Ethix and Cadaja for Section 469 purposes based upon the type of activity engaged in at Cadaja.

The district court determined this issue in favor of the petitioner based upon the language contained in 26 C.F.R. § 1.469-4(d)(5)(ii): An activity that a taxpayer conducts through a C corporation subject to § 469 may be grouped with *another activity* of the taxpayer, but only for purposes of determining whether the taxpayer materially or significantly participates in the other activity.⁶²

The district court’s next determination was whether the petitioner’s activities at Cadaja could be permissibly grouped together *with* his activities at Ethix for § 469 purposes. The district court determined this issue in favor of the petitioner based upon the language contained in 26 C.F.R. § 1.469-4(c)(1) and (2):

(1) One or more trade or business activities . . . may be treated as a single activity if the activities constitute an appropriate economic unit for measurement of gain or losses for purposes of section 469 . . . (2) [e]xcept as otherwise provided in this section, whether activities constitute an appropriate economic unit and, therefore, may be treated as a single activity depends upon all the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. The factors listed below, not all of which are necessary for a taxpayer to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute

an argument under the material participation claim” and not the Claim of Refund as a whole. *Id.* Third, the district court reasoned “[r]equiring that a taxpayer list all possible arguments for each test under material participation claims was unreasonable”. *Id.* Fourth, the plaintiff’s “grouping” “argument was not frivolous and was raised in good faith.” *Id.* Fifth, the IRS had adequate notice to respond to the “grouping” argument because the district court asked each party to “address whether Ethix Corporation, a C Corporation, and Cadaja, a limited liability company, can be grouped for the purpose of Treas. Reg. § 1.469.” *Id.*

⁶¹ *Id.* at 1132.

⁶² *Id.*

an appropriate economic unit for the measurement of gain or loss for purposes of section 469. . . (i) [s]imilarities and differences in types of trade or businesses; (ii) [t]he extent of common control; (iii) [t]he extent of common ownership; (iv) [g]eographical location; and (v) [i]nterdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records.).”⁶³

The district court noted that both Ethix Corporation and Cadaja, LLC had “significant similarities” because they were both “personal service activities and providing counseling, marketing, networking and business services to the health care industry.”⁶⁴ The fact that Ethix Corporation was involved with “traditional medicine” and Cadaja, LLC was involved with “alternative medicine” was immaterial to the District Court’s analysis.⁶⁵ Next, the district court noted the petitioner had common control over Ethix Corporation and Cadaja, LLC because he was the “CEO of Ethix Corporation . . . and a founding member and managing member of Cadaja.”⁶⁶ Then, the district court noted Ethix Corporation and Cadaja had a common ownership connection because the petitioner had a majority interest in both of them.⁶⁷ Last, the district court noted Ethix and Cadaja had a common geographic location since both had “their principal places of business in Portland, Oregon.”⁶⁸

Since the district court allowed the petitioner to group together his activities at Ethix and Cadaja as a “single activity” for purposes of 26 C.F.R. § 1.469-5T(a)(5) and (a)(6), the district court held the petitioner was also permitted to group together his 500-plus hours of participation at Ethix from January of 1994, to November 4, 1994, with his participation at Cadaja from November 4, 1994, as a “single activity” for purposes of 26 C.F.R. § 1.469-5T(a)(1). The district court then held that because the petitioner was able to satisfy the material participation test set forth in 26 C.F.R. § 1.469-5T(a)(1), his “ratable share of flow-through operating loss from Cadaja should be characterized as ordinary loss for tax year 1994.”⁶⁹

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.* at 1133. The IRS asserted that despite successfully grouping together his activities at Ethix Corporation and Cadaja, LLC as a single activity, the petitioner could not satisfy either the three or five year time requirement set forth in 26

What is noteworthy about the district court's holding in *Gregg* is the decision that the limited partner test contained in 26 C.F.R. § 1.469-5T(e)(3)(i)(B) did not apply to members of a limited liability company. However, the district court's holding that the petitioner's losses were ordinary and not passive was based upon the test set forth in 26 C.F.R. § 1.469-5T(a)(1), which is one of the three material participation tests available for a taxpayer who *is considered to be a limited partner in a limited partnership* to demonstrate his or her material participation. This irony put aside, the district court's decision that the limited partner test of 26 C.F.R. § 1.469-5T(e)(3)(i)(B) was inapplicable to taxpayers with interests in an LLC, and that such taxpayers should be able to demonstrate their material participation pursuant to all seven tests set forth in 26 C.F.R. § 1.469-5T(a)(1)-(7) would prove to be very persuasive to the Tax Court in *Garnett*.

III. TAX COURT AND *GARNETT*

The petitioners in *Garnett* held direct and indirect interests in both LLCs and LLPs that were active in the agribusiness industry.⁷⁰ From 2000

C.F.R. § 1.469-5T(a)(5)-(a)(6) because of the fact that Ethix Corporation was a "non-pass through C Corporation." *Gregg*, 186 F. Supp. 2d at 1133. This was relevant because "[a]ccording to temporary regulations in effect for 1991 and earlier years, a taxpayer could not be considered materially participating in an activity in a non-pass-through C Corporation." *Id.* Thus, the IRS reasoned that the petitioner could satisfy neither 26 C.F.R. § 1.469-5T(a)(5) nor (a)(6) and was not a material participant in Cadaja, LLC in the taxable year of 1994. *Id.* In response, the district court noted the IRS' argument "had merit", but ultimately rejected it because of the petitioner's aforementioned ability to demonstrate his material participation under 26 C.F.R. § 1.469-5T(a)(1). *Id.*

⁷⁰ *Garnett*, 132 T.C. No. 19 at 3-4. The Garnetts were living in Nebraska at the time they filed their petition for a refund. *Id.* They directly held their interests in one LLP and one LLC. *Id.* Through a series of holding LLCs named "Garnett Family Farms," the Garnetts' indirectly held interests in six LLPs and one LLC. *Id.* All of the Garnetts' interests were held in LLCs and LLPs that were organized under the laws of the State of Iowa, pursuant to Iowa Code Ann. § 486A.101. *Id.*

For chart below, see Chris Wright, *Passive Activity Losses and LLC Interests*, TAX LAW REP., July 10, 2009, http://taxlaw.typepad.com/tax_law/2009/07/passive-activity-losses-and-llc-interests.html.

Business Entity	Type of Ownership	Percentage of Ownership
Quality Poultry and Eggs	Direct Ownership/ LLP	11.11%
Elite Pork Partnership	GFF / LLP	11.11%
Center Fresh Egg Farm	GFF I/ LLP	12.5%

to 2002, the petitioners used losses from their LLC and LLP interests to offset their ordinary income.⁷¹ On their Schedule K-1 for the taxable years in question, the petitioners identified each holding LLC for the LLPs from which they were reporting income and expenses, and identified Mr. Garnett as a “limited partner” in said LLPs.⁷² The petitioners also identified on their Schedule K-1 their direct ownership interest in one LLC, and the holding LLC for another LLC, in which they held an indirect interest and identified Mr. Garnett as a “limited liability company member” therein.⁷³

After a determination by the IRS that the petitioners did not materially participate in the LLCs and LLPs because their interests were held as “limited partnership interests” within the meaning of § 469(h)(2), the IRS Commissioner disallowed their deductions under § 469(a) and issued a notice of deficiency and assessment of penalties in accordance with § 6662(a).⁷⁴

Cedar Valley Egg Farm	GFF II/ LLP	10%
Fremont Farms of Iowa	GFF III/ LLP	7.5%
Poweshiek County Pullets	GFF III/ LLP	7.5%
Iowa Quality Pullets	GFF IV/ LLP	10%
Single Poultry Source	GFF IV/ LLC	110.12%
Fremont Farms	Direct Ownership/ LLC	16.66%

⁷¹ Wright, *supra* note 70.

⁷² Garnett, 132 T.C. No. at 2. The LLP agreements for the business entities in which the Garnett’s held their interests and in which Mr. Garnett was listed as a “limited partner,” stated that each “partner” would actively participate in the control, direction and management of the partnership’s business and would not be liable for the debts and obligations of the LLP. *Id.*

⁷³ *Id.* The LLC operating agreements stated that a majority of the company’s members would elect a managing member who would have sole authority to act on behalf of the company. *Id.* Of the two LLC’s that were not holding companies, Single Source Poultry [indirect interest] and Fremont Farms [direct interest], Mr. Garnett was not a managing member. *Id.* However, Mr. Garnett was a managing member of the holding LLC’s GFF I, and GFF II. *Id.* At the time of this writing there is no information available as to the managing member of GFF, GFF III or GFF IV. *Id.*

⁷⁴ Garnett, 132 T.C. No. 19 at 1.

Year	Deficiency	Penalty
2000	\$170,268	\$34,054
2001	\$110,300	\$22,060
2002	\$80,900	\$16,180

The code provision reads: “Imposition of penalty.—If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall

In the United States Tax Court, the issue⁷⁵ presented was whether or not the petitioners' interests in the LLCs and LLPs were appropriately considered by the IRS to be held as a limited partnership interests, thereby rendering them passive *per se* and subject to § 469(h)(2) and the limitations for demonstrating material participation under 26 C.F.R. § 1.469-5T(a)(1)-(7) and 1.469-5T(e)(2).

A. The Parties' Positions

In their cross-motion for summary judgment, the IRS' position was that (1) the petitioner's interests met the definition of a limited partnership interest under 26 C.F.R. § 1.469-5T(e)(3)(i)(A)-(B),⁷⁶ and (2) the petitioners were not general partners.⁷⁷ The petitioners' position was that § 469(h)(2) was inapplicable to their interests because: (1) none of the business entities in which they held their interests were a limited partnership, and (2) they should be considered general partners in their business entities rather than limited partners.⁷⁸

B. The United States Tax Court Rejects Both Parties' Positions

The United States Tax Court held the IRS' position was uninclusive because in addition to holding a limited partnership interest, a taxpayer had to also hold his or her limited partnership interest as a *limited*

be added to the tax an amount equal to 20 percent of the portion of underpayment to which this section applies." I.R.C. § 6662(a) (West 2010).

⁷⁵ The issue of the Garnetts' interests in the Garnett Family Farms holding LLCs was not before the Tax Court: "Respondent states: '[t]hat petitioners mostly held their interests indirectly (through Garnett Family Farm entities) is of no consequence.'" *Garnett*, 132 T.C. No. 19 at 13 n.13.

⁷⁶ See, e.g., 26 C.F.R. § 1.469-5T(e)(3) for the definition of a limited partnership interest. According to the IRS, "the sole relevant consideration" with respect to how to characterize the petitioner's interests was whether or not they enjoyed limited liability protection "with respect to their ownership interests." *Garnett*, 132 T.C. No. 19 at 5. Since limited liability protection under the state law in which the partnership is organized is one of the conditions of holding a limited partnership interest under 26 C.F.R. § 1.469-5T(e)(3)(i)(B), and because the petitioners had limited liability protection under Iowa law, the IRS asserted the petitioners interests should therefore be characterized as limited partnership interests and subject to the limited partner restriction set forth in I.R.C. § 469(h)(2). *Id.*

⁷⁷ *Id.*

⁷⁸ In support of their propositions, the Garnett's relied upon *Gregg v. United States*, in which the United States District Court for the District of Oregon held that I.R.C. § 469(h)(2) did not apply to a member of a limited liability company registered in the state of Oregon. *Garnett*, 132 T.C. No. 19 at 14.

partner in order to be subject to § 469(h)(2).⁷⁹ However, the United States Tax Court was unwilling to adopt the petitioners' argument regarding the definition of a "limited partner" because of certain language contained in the legislative history regarding § 469(h)(2).⁸⁰

In a 1986 report regarding the enactment of the TRA, the Senate indicated the Secretary of the United States Treasury would have the authority to treat "substantially equivalent entities as limited partnerships for purposes of § 469(h)(2)."⁸¹ With this language, the United States Tax Court reasoned that, "[a]s a corollary, it would appear Congress also contemplated that some ownership interests in such 'substantially equivalent entities' might be treated as interests held by limited partners."⁸² The United States Tax Court then noted that "[a]t first glance" the definition of a limited partnership interest set forth in 26 C.F.R. § 1.469-5T(e)(i)(B) "might appear" to treat an interest held in an LLC or LLP as a "limited partnership interest" since interests held in LLCs and LLPs provide limited liability protection and limited liability protection is one of the conditions under the aforementioned Temporary Treasury Regulation of a limited partnership interest.⁸³ Thus, the United States Tax Court held that in order to decide if the definition of a limited partnership interest set forth by the Secretary of the United States Treasury in 26 C.F.R. § 1.469-5T(e)(3)(i)(B) was to be read as treating LLCs and LLPs as "substantially equivalent" to limited partnerships, and consequently the interests held therein to be held as limited partnership interests, it was necessary to decide to what extent the "general partner exception" set forth in 26 C.F.R. § 1.469-5T(e)(3)(ii) applied to LLC and LLP interests.⁸⁴ The United States

⁷⁹ *Id.* at 16 (emphasis added).

⁸⁰ The petitioners' proposed definition of a limited partner was: a limited partner is only a limited partner of a business entity that is a limited partnership under state law and since neither an LLC nor an LLP is "strictly speaking," a limited partnership, then a member thereof should not be considered a limited partner. *Id.* at 16.

⁸¹ *Garnett*, 132 T.C. No. 19 at 20. With this analysis, the United States Tax Court undercut the Petitioner's proposed definition of a limited partner because if an LLC and an LLP can be considered to be the "substantial equivalent" of a limited partnership based upon an interpretation of 26 C.F.R. § 1.469-5T(e)(3)(1), then a business entity would not "strictly speaking" have to be registered under state law as a limited partnership in order for interests held therein to be considered interests held as a limited partner. *Id.* Therefore, the Tax Court was unwilling to adopt the Petitioner's narrow definition of what constituted a limited partner. *Id.* at 19.

⁸² *Id.*

⁸³ *Id.* at 22.

⁸⁴ *Id.* at 23 n.21. According to 26 C.F.R. § 1.469-5T(e)(3)(B)(ii), the "general partner exception" reads:

Limited partner holding a general partner interest. A partnership interest of an individual shall not be treated as a limited

Tax Court then asserted, “[i]f the general partner exception applies,” the petitioner’s ownership interests “shall not be treated as a limited partnership interest” and the court would not need to define “limited partner” because the limited partnership restriction set forth in § 469(h)(2) would not apply to the petitioner’s interests.⁸⁵

C. The General Partner Exception

The petitioners asserted that because (1) under Iowa law, they “were not precluded from actively participating in the operations and management” of their LLCs and LLPs, and (2) “were given at least some role to play” in their LLCs and LLPs, they should be considered general partners therein.⁸⁶ While the IRS stipulated to those facts, they nevertheless asserted the definition of a general partner should be, “one who has authority, actual or apparent, to act for and bind the copartnership.”⁸⁷ The IRS proposed this adoption because it would render the petitioners usage of the term “general partner” insufficient to encompass their involvement in their LLCs and LLPs since, “[t]he partnership agreements here did not give petitioners the authority to take action on behalf of the partnerships as a general partner would (nor did petitioners function like they were general partners).”⁸⁸

The IRS further asserted that in conjunction with its proposed definition of a general partner, it was necessary for the United States Tax Court to inquire “into the nature and extent of petitioners’ authority to act on behalf of the LLPs and the LLCs.”⁸⁹ Implicit in the IRS’ proposition was that in a § 469(h)(2) case, if such an inquiry revealed that a taxpayer’s level of involvement in, and authority to act on behalf of, his or her LLCs and LLPs was sufficient to meet the proposed definition of a general partner, then the general partner exception would apply, and § 469(h)(2) would not. The United States Tax Court, however, refused to adopt this

partnership interest for the individual’s taxable year if the individual is a general partner in the partnership at all times during the partnership’s taxable year ending with or within the individual’s taxable year (or portion of the partnership’s taxable year during which the individual (directly or indirectly) owns such limited partnership interest”).

⁸⁵ *Garnett*, 132 T.C. No. 19 at 22.

⁸⁶ *Id.* at 25-26.

⁸⁷ *Id.* at 24 (citing *Giles v. Vette*, 263 U.S. 553, 560 (1924) (The Tax Court refused to adopt this definition on grounds that “[t]he Court in *Giles* was less concerned with the definition of a general partner than with the existence of a partnership.”).

⁸⁸ *Garnett*, 132 T.C. No. 19 at 26.

⁸⁹ *Id.* at 7.

proposed inquiry for § 469(h)(2) upon the grounds that such an inquiry would be “closely akin to factual inquiries appropriately made under the general tests for material participation” and that “[t]o import them into the per se rule of section 469(h)(2) . . . would . . . blur that special rule and the general rules for material participation in a manner that is at odds with the statutory framework and legislative intent.”⁹⁰

D. Conclusion: The Petitioners Held Their Interests as General Partners

The United States Tax Court then held that in cases concerning interests held by taxpayers in LLCs and LLPs, “it is necessary to examine the facts and circumstances to ascertain the nature and extent of their participation . . . pursuant to the general tests for material participation under section 469” and not § 469(h)(2) because “it cannot be presumed” that those who hold such interests “do not materially participate.”⁹¹ In support of this holding, the United States Tax Court noted that:

While limited liability was one characteristic of limited partners that Congress considered in the enactment of section 469(h)(2), it clearly was not, as respondent suggests, the sole or even determinative consideration. To the contrary, the more direct and germane consideration was *the legislative belief that statutory constraints on a limited partner’s ability to participate in the partnership’s business justified a presumption that a limited partner generally does not materially participate and made further factual inquiry into the matter unnecessary.*⁹²

The United States Tax Court then noted that the Congressional rationale quoted above for treating limited partners in a limited partnership as not being material participants therein does not properly extend “to interests in LLPs and LLCs” since “members of LLPs and LLCs, unlike

⁹⁰ *Id.* To support this belief that a general material participation examination under I.R.C. § 469(h)(2) cases would be contrary to legislative intent, the United States Tax Court cited language from a Senate Report stating, “[S]ince a limited partner generally is precluded from participating in the partnership’s business if he is to retain his limited liability status, *the committee believes it should not be necessary to examine general facts and circumstances regarding material participation in this context.*” S. REP. NO. 99-313, at 720 (1986) (emphasis added).

⁹¹ *Garnett*, 132 T.C. No. 19 at 7. The “general material participation tests pursuant to rule 469” referenced by the United States Tax Court are the seven aforementioned tests set forth in 26 C.F.R. § 1.469-5T(a)(1)-(7).

⁹² *Garnett*, 132 T.C. No. 19 at 7 (emphasis added).

limited partners in State law limited partnerships, are not barred by State law from materially participating in the entities' business."⁹³

With that, the United States Tax Court rendered its ultimate holding that the petitioners held interests in their LLCs and LLPs as general partners, and not limited partners, for purposes of § 469.⁹⁴

IV. UNITED STATES COURT OF FEDERAL CLAIMS AND *THOMPSON*

The petitioner in *Thompson* held a ninety-nine percent direct ownership interest in an LLC organized under the laws of the state of Texas.⁹⁵ After an assessment of the petitioner's tax returns for the taxable years of 2002 and 2003, the IRS disallowed all his claimed losses in 2002 and a portion of those claimed in 2003 and issued a notice of deficiency.⁹⁶

⁹³ *Id.*

⁹⁴ *Id.* at 8. In addition to this holding, the United States Tax Court added, "[i]n doing so, we recognize that petitioners' status in these entities differs significantly from the status of general partners in State law limited partnerships, but we also recognize that their status differs significantly from that of limited partners in State law limited partnerships." *Id.*

⁹⁵ *Thompson*, 87 Fed. Cl. at 730. The taxpayer organized Mountain Air Charter, LLC in 2002, in which he held his ninety-nine percent direct ownership interest. *Id.* Mountain Air Charter, LLC owned and operated a single airplane and provided on-demand air transportation services. *Id.* at 730 n.3. The Taxpayer held the remaining one percent interest in Mountain Air Charter, LLC indirectly through JRT Holdings, Inc. *Id.* at 730. Mountain Air Charter, LLC's Articles of Organization listed the plaintiff as its only manager. *Id.* at 731.

Mountain Air Charter, LLC was taxed as a partnership for federal taxation purposes because the taxpayer did not elect how he wished for it to be classified and taxed, and Mountain Air, LLC was an "eligible entity." *Id.* This is known as the "default" rule, and it is contained in the check-the-box regulations. The specific provision governing this case, and many other limited liability companies and limited liability partnerships that do not "check-the-box" and are therefore treated as a partnership for federal taxation purposes by default because they are "eligible entities," is: "(b) Classification of eligible entities that do not file an election – (1) Domestic eligible entities. Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is – (i) A partnership if it has two or more members." 26 C.F.R. § 301.7701-3 (2009).

⁹⁶ Mountain Air Charter, LLC had losses of \$1,225,869 in 2002 and \$939,878 in 2003. *Thompson*, 87 Fed. Cl. at 731. In addition to disallowing the claimed losses, the IRS issued a notice of deficiency, plus interest, in the amounts of \$437,186 for 2002 and \$308,055 for 2003. *Id.* The petitioner paid the amounts assessed and sued for a refund on September 9, 2005; the IRS denied the petitioner's claim on March 2, 2006, and he filed suit in the United States Court of Federal Claims two weeks later. *Id.*

The IRS's position for disallowing the claimed losses was that the petitioner was not a material participant in his LLC and, under § 469(a), could not use his passive activity losses to offset his ordinary income.⁹⁷ The United States Court of Federal Claims held that the sole issue before the court was whether the IRS correctly treated the petitioner's interest in his LLC as a "limited partnership interest" under 26 C.F.R. § 1.469-5T(e)(3)(i)(A)-(B).⁹⁸

In its motion for summary judgment, the United States asserted that the IRS was correct in its treatment of the petitioner's losses because the petitioner's LLC was both taxed as a partnership and he enjoyed limited liability protection under Texas state law.⁹⁹ In his motion for summary judgment, the petitioner asserted that because his LLC was not a limited partnership under Texas state law, his interest could not be held as that of a "limited partner."¹⁰⁰ Further, the petitioner asserted that even if his LLC was a limited partnership, his interest held therein would be more akin to that of a general partner, not a limited partner, because of the high degree of control he exercised over management.¹⁰¹

The United States Court of Federal Claims held that the petitioner did not hold his interest in his LLC as a limited partner in a limited partnership and that he should be allowed to demonstrate his material participation in accordance with tests set forth in 26 C.F.R. § 1.469-5T(a)(1)-(7).¹⁰²

The United States Court of Federal Claims first noted that before an interest could be held as a "limited partnership interest," the plain meaning

⁹⁷ *Thompson*, 87 Fed. Cl. at 731. In *Thompson*, the IRS relied upon the text of 26 C.F.R. § 1.469-5T(e)(3)(i)(B), which treats any interest that enjoys limited liability protection as a limited partnership interest. *Id.* Since the petitioner enjoyed limited liability protection in Mountain Air Charter, LLC in accordance with Texas law, the IRS argued that his ninety-nine percent interest therein was a limited partnership interest and was subject to the restrictions set forth in I.R.C. § 469(h)(2). *Id.* at 733. Further, the IRS's determination was that the petitioner was unable to demonstrate that he was a material participant in Mountain Air Charter, LLC under the tests set forth in 26 C.F.R. § 1.469-5T(a)(1), (5) or (6). *Id.* at 731.

⁹⁸ *Id.* at 730.

⁹⁹ *Id.* at 733.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Thompson*, 87 Fed. Cl. at 739. The United States Court of Federal Claims in *Thompson* went on to note that it was not necessary for the petitioner to demonstrate his material participation in accordance with the tests set forth in 26 C.F.R. § 1.469-5T(a)(1)-(7) because the defendant conceded that if it was found the petitioner did not hold his interest in Mountain Air Charter, LLC as a "limited partnership interest," then he would be able to demonstrate his material participation. *Id.*

of 26 C.F.R. § 1.469-5T(e)(3)(i)(B) indicated that the interest must be held in a partnership, which an LLC is not.¹⁰³ Next, the United States Court of Federal Claims noted that the petitioner was not a “limited partner” of a limited partnership; rather, he was a “member” of an LLC.¹⁰⁴ Finally, the United States Court of Federal Claims noted that even if the two aforementioned conditions had not been met, the petitioner would most likely not hold his interest in his LLC as a limited partner because he would satisfy the “general partner exception.”¹⁰⁵

¹⁰³ *Thompson*, 87 Fed. Cl. at 734. The United States Court of Federal Claims relied upon the *Chevron* test with respect to interpreting Congressional statutes and administrative agencies that are charged with enforcement of that statute: if Congress’ intent is clear, meaning it is unambiguous, from the text of the statute, then courts, as well as said administrative agencies, must defer to Congress’ intent. *Id.* With respect to the limited partner test set forth in 26 C.F.R. § 1.469-5T(e)(3)(i), the United States Court of Federal Claims interpreted Congress’ intent, from the plain meaning of the Temp. Reg., to indicate that an interest must be held in partnership under state law, and not just a business entity that is taxed as a partnership under federal law, in order for that interest to be considered a limited partnership interest. *Id.* Under Texas law, and every other state, a limited liability company is not a partnership because the latter must distinguish “general partners” from “limited partners” for material participation and liability purposes; whereas, a limited liability company does not have to make a distinction between its members because they can all be material participants and enjoy limited liability protection. *Id.* at 733. Thus, under the plain meaning of 26 C.F.R. § 1.469-5T(e)(3)(i), the plaintiff’s ninety-nine percent interest held in his limited liability company was not a limited partnership interest. The court also rejected the defendant’s position that it, the court, had to defer to an agency regulation that was set forth in a manner which was reasonable based upon the applicable statute. *Id.* at 734 n.7. The court ruled that, once again, Congress’ intent was unambiguous and further, the IRS had never issued a regulation that expressly stated interests held as members in limited liability companies and partners in limited liability partnerships were to be treated as limited partnership interests, that this was just a “convenient litigation” point. *Id.*

¹⁰⁴ *Thompson*, 87 Fed. Cl. at 734. The court noted this further distinction because, “[t]he operative condition for applying I.R.C. § 469(h)(2) is not simply that there be ‘an interest in a limited partnership’ but an ‘interest in a limited partnership as a limited partner.’” *Garnett*, 132 T.C. No. 19 at 5. As previously mentioned, the court already held that the plaintiff’s limited liability company was not a limited partnership. *Thompson*, 87 Fed. Cl. at 734. Thus, its statement that the plaintiff was a member, and not a limited partner, was even further supportive of its rejection of the defendant’s position that the limited partnership test of 26 C.F.R. § 1.469-5T(e)(3)(i) applied, since no part of that test could be seen as applying to the plaintiff as a member of his limited liability company.

¹⁰⁵ *Thompson*, 87 Fed. Cl. at 734. See also 26 C.F.R. § 1.469-5T(e)(3)(B)(ii), which provides the definition and explanation of the “general partner exception.” Further, the United States Court of Federal Claims noted that twice, at oral

V. CONCLUSION

After *Garnett* and *Thompson*, taxpayer losses attributable to interests held in LLCs and LLPs will no longer be considered passive *per se*. Since § 469(h)(2) will not automatically¹⁰⁶ apply to their losses, members and partners will now have the benefit of using all seven of the enumerated tests set forth in 26 C.F.R. § 1.469-5T(a)(1)-(7) to demonstrate their material participation and could potentially be entitled to deduct losses attributable to their LLC and/or LLP interests from ordinary income pursuant to § 469(a).¹⁰⁷

argument, the defendant “conceded” that the petitioner would be a “general partner” if the limited liability company in question was a limited partnership. *Thompson*, 87 Fed. Cl. at 735. The United States Court of Federal Claims referred to the defendant’s position as “self-serving” and “contradictory,” that it wanted the court to treat the petitioner’s interest in the limited liability company as a limited partner interest held in a limited partnership under 26 C.F.R. § 1.469-5T(e)(3)(i), but did not want the court to consider the petitioner’s interest in the limited liability company as a “limited partnership interest” in a limited partnership for purposes of the “general partner exception” under 26 C.F.R. § 1.469-5T(e)(3)(iii): “[i]f an LLC member could hold a limited partner’s interest . . . then, alternatively, that same member could hold a general partner’s interest . . .” *Id.*

¹⁰⁶ I.R.C. § 469(h)(2) will apply in the event the taxpayer is unable to satisfy any of the seven tests set forth in 26 C.F.R. § 1.469-5T(a)(1)-(7). If taxpayers are unable to satisfy any of the seven tests, they will be considered passive members and partners and their losses will be subjected to the restrictions of I.R.C. § 469(a), (h)(2).

¹⁰⁷ The test in 26 C.F.R. § 1.469-5T(a)(4), which is not one of the three tests that may be used by taxpayers to whom I.R.C. § 469(h)(2) applies, is considered to be the most generous to taxpayers because they must simply demonstrate that they have spent 500 or more hours participating in all of their significant participation activities for the taxable year in question.

- 26 C.F.R. § 1.469-5T(c) defines a “significant participation activity” as: “(i) a trade or business activity (within the meaning of 26 C.F.R. 1.469-1T(e)(2)) in which the individual significantly participates for the taxable year; and (ii) [w]ould be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section.”
- 26 C.F.R. § 1.469-5T(c)(2) defines “significant participation” as: “[a]n individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.”
- 26 C.F.R. § 1.469-1T(e)(2) defines “trade or business activity” as it is defined in 26 C.F.R. § 1.469-4(b)(1): “[t]rade or business activities are activities, other than rental activities or activities that are treated under Sec. 1.469-1T(e)(3)(vi)(B) as incidental to an activity of holding

A. *Hegarty v. Commissioner: The United States Tax Court Uses
Garnett to Justify Taxpayer-Friendly Decision.*

One example of taxpayers already benefiting from *Garnett* and *Thompson* and the newfound ability to use all seven tests set forth under 26 C.F.R. § 1.469-5T(a)(1)-(7) is *Hegarty v. Commissioner*.¹⁰⁸ In *Hegarty*,¹⁰⁹

property for investment, that-- (i) [i]nvolve the conduct of a trade or business (within the meaning of section 162); (ii) [a]re conducted in anticipation of the commencement of a trade or business; or (iii) [i]nvolve research or experimental expenditures that are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).”

¹⁰⁸ *Hegarty*, 2009 Tax Ct. LEXIS 154, at *8. As indicated in the text of the opinion and pursuant to I.R.C. § 7463(b), the Tax Court’s Summary Opinion in *Hegarty* “may not be treated as precedent for any other case.” *Id.*

¹⁰⁹ *Id.* at 2-41. The petitioner referred to in *Hegarty* is the husband, Sean Kieran Hegarty. *Id.* On August 1, 2003, petitioner and his wife, Mrs. Kerry Ann Hegarty, formed Blue Marlin, LLC under the laws of the State of Maryland with each owning a fifty percent interest in the business. *Id.* In addition to operating Blue Marlin, LLC, the petitioner was employed with a mortgage company and Mrs. Hegarty was a real estate salesperson. The petitioner and Mrs. Hegarty created the Blue Marlin LLC in order to use their forty-six-foot Post luxury cruiser for the purpose of chartering fishing excursions. *Id.* As the Tax Court indicated, the petitioner and Mrs. Hegarty were the only two persons involved in operating the business and maintained a written log in which they recorded the amount of time they spent operating the business. *Id.* However, when the petitioner and Mrs. Hegarty moved from Washington D.C. to Florida, the written log was lost. *Id.* Nonetheless, the petitioner and Mrs. Hegarty were able to use business receipts to demonstrate that their participation in operating the business during 2003 exceeded 100 hours but was less than 500 hours. *Id.*

The petitioner and Mrs. Hegarty did not choose to treat Blue Marlin LLC as an entity separate from themselves for federal taxation purposes. *Id.* With that treatment, on Form 1065, U.S. Return of Partnership Income, the petitioner and Mrs. Hegarty reported the following for Blue Marlin, LLC in 2003:

Blue Marlin, LLC	Income	Expenses	Net Gain	Net Loss
	\$9,583	\$74,161- (\$26,173 attributable to depreciation expense)	N/A	(\$64,578)

Id. The \$64,578 net loss from Blue Marlin, LLC in 2003 was deducted on the petitioner and Mrs. Hegarty’s 2003 Schedule E, Supplemental Income and Loss,

the IRS Commissioner disallowed the taxpayer-petitioner's claimed loss on his Schedule E, Supplemental Income and Loss, stemming from the net loss of the Blue Marlin, LLC, a Maryland limited liability company. The Commissioner issued its notice of deficiency on the grounds that during 2003, the petitioner's interest in Blue Marlin, LLC was a passive activity because the petitioner did "not materially participate in the business" of Blue Marlin, LLC.¹¹⁰ The United States Tax Court held that while its members "would be reluctant" to find that the petitioner "did" materially participate in the operation of the Blue Marlin, LLC's business in 2003, such a finding was "not necessary" "for reasons discussed in *Garnett v.*

and included with their joint 2003 Federal income tax return. *Id.* On November 21, 2006, the Commissioner issued a notice of deficiency for the petitioner and Mrs. Hegarty's joint 2003 Federal income tax return in the amount of \$23,366.

Id.

¹¹⁰ *Hegarty*, 2009 Tax Ct. LEXIS 154, at *6. The basis of the Commissioner's argument rested upon the fact that the Blue Marlin, LLC was operated as a limited liability company. *Id.* at 2. Since the petitioner and Mrs. Hegarty's business was operated as a limited liability company, the Commissioner reasoned that each of their interests were held as a limited partner in a limited partnership and, therefore, the petitioner and Mrs. Hegarty were presumably not material participants in Blue Marlin, LLC in 2003. *Id.* at 2. With that, the petitioner would be only be able to overcome that presumption by proving he and Mrs. Hegarty materially participated in the Blue Marlin, LLC pursuant to 26 C.F.R. § 1.469-5T(e)(2), which provides that only 26 C.F.R. § 1.469-5T(a)(1), (5) and (6) are available for such limited partners and material participation tests. *Id.* Since the petitioner and Mrs. Hegarty had only been involved in the operation of the Blue Marlin, LLC for one year in 2003, 26 C.F.R. § 1.469-5T(a)(5) and (6) were both inapplicable:

- 26 C.F.R. § 1.4695T(a)(5) - The taxpayer materially participated in the activity for any 5 taxable years, whether or not consecutive, during the 10 taxable years immediately preceding the taxable year. *Id.*
- 26 C.F.R. § 1.469.5T(a)(6) - The activity is a personal service activity and the taxpayer materially participated in the activity for any 3 taxable years, whether or not consecutive, preceding the taxable year. *Id.*

As a result, the Commissioner reasoned the only remaining test for the petitioner to use to demonstrate that he and Mrs. Hegarty were material participants in 2003 was: "26 C.F.R. § 1.469-5T(a)(1) - The taxpayer participates in the activity for more than 500 hours during such year." *Id.*

Since the petitioner and Mrs. Hegarty only participated in the operating of the Blue Marlin, LLC for more than 100 hours but less than 500 hours in 2003, the Commissioner held that the petitioner and Mrs. Hegarty were not material participants and that the Blue Marlin, LLC was a passive activity from which the petitioner and Mrs. Hegarty could not use a net loss to offset their ordinary income. *Id.*

Commissioner."¹¹¹ The Tax Court held that because the petitioner participated in the operation of Blue Marlin, LLC's business for more than 100 hours in 2003, and this participation "was not less" than the participation of any other individual with an interest in the Blue Marlin, LLC during 2003, the petitioner was not subject to the limited partner restriction of § 469(h)(2).¹¹²

*B. Section 1402 Self-Employment Taxes: The Potential Negative
Consequence of Garnett and Thompson*

Section 1402 of the IRC imposes a tax on self-employment income.¹¹³ Included among the items that are subject to self-employment tax under § 1402(a) is a taxpayer's "[d]istributive share (whether or not distributed) of income or loss described in section 702 (a)(8)"¹¹⁴ from any

¹¹¹ *Hegarty*, 2009 Tax Ct. LEXIS, at *3. The Tax Court noted that in *Garnett*, it held the Commissioner's "reliance upon Section 469(h)(2)" was "misplaced" and that taxpayers who are involved in the operation of a limited liability company can demonstrate that they were material participants pursuant to all seven of the tests enumerated in 26 C.F.R. § 1.469-5T(a)(1)-(7), rather than being limited to only 26 C.F.R. § 1.469-5T(a)(1), (5) and (6) as is indicated in 26 C.F.R. § 1.469-5T(e)(2). *Id.*

¹¹² *Id.* The Tax Court's holding was based upon:

26 C.F.R. § 1.469-5T(a)(3)- The taxpayer participates in the activity for more than 100 hours during the taxable year, and the taxpayer's participation in the activity for the taxable year is not less than the participation in the activity of any other individual, including individuals who do not own interests in the activity, for such taxable year.

Id. at *2. The Tax Court noted that it was "satisfied" that the petitioner and Mrs. Hegarty had participated in the operation of Blue Marlin, LLC for more than 100 hours during 2003 and was "further satisfied" that the petitioner and Mrs. Hegarty's participation of more than 100 hours of the operation of Blue Marlin, LLC was not less than the participation of any other individual. *Id.*

Of note is the fact that in the Tax Court's "further satisfaction" explanation, it cited the following: "26 C.F.R. § 1.469-5T(a)(2). The taxpayer's participation in the activity for the taxable year constitutes substantially all of the participation in such activity for all individuals, including individuals who do not own interests in the activity, for such taxable year." *Id.*

¹¹³ I.R.C. § 1402 (2006).

¹¹⁴ I.R.C. § 702(a)(8) reads: "(a) General Rule. In determining his income tax, each partner shall take into account separately his distributive share of the partnership's - (8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection."

trade or business carried on by a partnership of which he is a member”¹¹⁵ Further, subsection (a), paragraph (13) of § 1402 reads:

“[t]here shall be excluded the distributive share of any item of income or loss of a *limited partner*, as such, other than guaranteed payments described in section 707 (c)¹¹⁶ to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.”¹¹⁷

Put together, this means the self-employment tax under § 1402 only applies to a partner’s distributive share of income, and not a limited partner’s share of income, subject to the aforementioned exception with respect to § 707(c) guaranteed payments. While this may seem inapplicable to members of LLCs and partners in LLPs, the *Garnett* and *Thompson* decisions may subject them to § 1402 self-employment taxes.

Just like in § 469 and the applicable Treasury Regulations related to material participation, the term “limited partner” is not defined in § 1402(a)(13).¹¹⁸ Nevertheless, taxpayers who argue that they should be treated as “general partners” rather than “limited partners” for § 469 and passive activity loss purposes, will have to set forth a seemingly contradictory argument that they should be considered “limited partners” and not “general partners” for § 1402 and self-employment tax purposes.¹¹⁹ The United States Tax Court’s detailed reasoning in *Garnett* that members of LLCs and partners of LLPs are more akin to “general partners” than “limited partners,” combined with the United States Court of Federal Claim’s holding in *Thompson* that such members and partners are not subject to the “limited partner” restriction of § 469(h)(2), will make taxpayers’ potential contradictory arguments, for § 469(h)(2) passive

¹¹⁵ I.R.C. § 1402(a).

¹¹⁶ I.R.C. § 707(c) reads:

To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61 (a) (relating to gross income) and, subject to section 263, for purposes of section 162 (a) (relating to trade or business expenses).

¹¹⁷ I.R.C. § 1402(a)(13) (emphasis added).

¹¹⁸ William M. Toomajian et al., *Hurdle Lowered for LLC/LLP Members to Avoid Passive Activity Loss Rules*, Aug. 11, 2009, http://www.martindale.com/business-law/article_Baker-Hostetler-LLP_772000.htm.

¹¹⁹ *Id.*

activity loss purposes and § 1402 self-employment tax purposes, even more difficult.¹²⁰

¹²⁰ *Id.*

